Supreme Court, U.S.
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No. 02-

IN THE

Supreme Court of the United States

GREG SEINFELD,

Petitioner,

v.

CAROL A. BARTZ; JOHN T. CHAMBERS; MARY A. CIRILLO; JAMES F. GIBBONS; EDWARD R. KOZEL; JAMES C. MORGAN; JOHN P. MORGRIDGE; ARUN SARIN; DONALD T. VALENTINE; STEVEN M. WEST; and CISCO SYSTEMS, INC.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

A. ARNOLD GERSHON
BALLON STOLL BADER & NADLER, P.C.
Attorneys for Petitioner
1450 Broadway
14th Floor
New York, New York 10018-2268
(212) 575-7900

181017

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

QUESTION PRESENTED

An important purpose of the Securities Exchange Act of 1934 is to promote honest and efficient stock and securities markets through informed investor decision by requiring full and fair disclosure, especially of financial information. Section 14(a) of the Act addresses this purpose by requiring fair corporate suffrage, which has been historically and still is essentially unprotected by state law. Accordingly, where a proxy statement solicits corporate stockholders to vote to approve a plan for the company to grant stock options, even if the annual cost of the options is 10 or 20 times the annual cash retainer to the directors, as reported in that proxy statement,

Does § 14(a) not require the proxy statement to disclose the cost of the stock options, either because:

1. Corporate stock options cannot be evaluated by Black-Scholes or any other way; or

2. There is no rule that requires such disclosure *in haec verba*, as it might for "children in kindergarten?"

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Appendix C — Statutory And Regulatory Provisions Involved 26a

Greg Seinfeld petitions the Supreme Court of the United States for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit is reported at 322 F.3d 693 (9th Cir. 2003) and reprinted at petitioner's appendix at 1a-13a. The opinion of the United States District Court for the Northern District of California dismissing the complaint is reported at 2002 WL 243597 (N.D. Cal. 2002) and reprinted at petitioner's appendix at 14a-25a.

STATEMENT OF JURISDICTION

The Court of Appeals entered judgment on March 7, 2003. The jurisdiction of this court is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTES, RULES, AND REGULATIONS INVOLVED

The Securities Exchange Act of 1934, § 14(a)
15 U.S.C. § 78n(a);

Securities and Exchange Commission Rules and Regulations
Rule 14a-9, 17 C.F.R. § 240.14a-9;

Schedule 14A, Items 8 and 10,
17 C.F.R. § 240.14a-101 (Item 8)(a), (b), and (d)
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Regulation S-K, Items 402(c) and 402(g),
17 C.F.R. § 229.402(c)(1) without Table,
(c)(2)(vi)(B), and Instruction 9;
17 C.F.R. § 229.402(g) and Instruction.

These provisions are lengthy and are reprinted in the petitioner's appendix at 26a.

STATEMENT OF THE CASE

The lower court, after repeated disparagement of Black-Scholes, concluded its opinion with the suggestion that stockholders should ask the SEC to require a Black-Scholes disclosure of stock option values in a proxy statement whenever it seeks stockholder approval of stock options. (12a) We suggest that this disparagement materially weakens any rule that the SEC might make. More seriously, it weakens existing rules that do require its use in corporate earnings statements and other applications, characterized as important by, *inter alia*, Federal Reserve Chairman Alan Greenspan.

This an action by a stockholder of Cisco Systems, Inc. ("Cisco" or the "Company") against its directors for distributing a false and misleading proxy statement. All ten individual defendants are directors of Cisco. Seven of them are non-employee directors.

As a part of Cisco's 1996 Stock Incentive Plan (the "Plan"), the board of directors included the Automatic Option Grant Program (the "Program"). The Program provides for an automatic, initial grant of an option to purchase shares of the Company's stock to each new non-employee director and an automatic, subsequent, annual grant of an option to purchase shares of the Company's stock to each re-elected non-employee

director on the date of re-election. The options are exercisable at the market price of the underlying stock on the date of grant. The options expire nine years from the date of grant or 12 months following termination of board service, whichever is earlier.

On July 8, 1999, the board of directors approved the Amendment to the Program. (E-75) Pursuant to the Amendment, the initial grant would increase from 20,000 to 30,000 shares, and the annual grant would increase from 10,000 to 15,000 shares. (E-3)

The complaint alleges that the defendants used a materially false and misleading Proxy Statement for the 1999 annual meeting to obtain stockholder approval of the Amendment. The Proxy Statement represents that each Non Employee Director was paid $32,000 per year plus options on 10,000 shares of the Company's stock for the fiscal year ending ("FYE") July 31, 1999 (E-4). The Proxy Statement did not disclose the fair value of the options granted in FYE 1999, *i.e.*, $369,500 (E-5). If the Amendment had been effective in FYE 1999, the value of each non-employee director's option would have been $554,250, 17 C.F.R. § 240.14a-101 (Item 10)(a)(2)(iii)(C) and Instruction 2, 32a, and with the $32,000 retainer, $586,250 (E-9). As a result of the stockholders' approval of the Amendment, the total annual compensation of each Non Employee Director in FYE 2000 was not $32,000, but $753,800.

The complaint, at ¶27, understates the value of a non-employee director's FYE 2000 compensation as increased by the Amendment, alleging that the value of each 15,000 share option was $630,900, when it was actually $721,800, and added to $32,000 it is $753,800. The understatement resulted from using the wrong pre-split price, *i.e.*, the complaint says "69.50

per share", instead of $79.50, the product of 2 times $39.75. See Cpl. ¶16 (E-4), ¶27 (E-9), and the historical post-split price table at November 10, 1999 (E-44). This was the compensation to each non employee director for eight meetings, and they need not have attended every single one to get paid this much.

The complaint, at ¶¶18, 21, (E-5, 6) alleges that the Company itself evaluates the stock options that it grants and that it uses the Black-Scholes option pricing model. Thus, the Company's Form 10K for its fiscal year ending July 31, 1999, in note 9 to its financial statements, states, "[T]he fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions (then listed). . . ." (E-79).

The Proxy Statement could have included the values of the stock options granted to the non-employee directors in FYE 1999, for the numbers actually existed in the Company's possession. (Cpl. ¶¶16-18; (E-4, 5)). Accordingly, there was no need to make calculations, for that work had already been done. All that was required was to share it with the stockholders.

The lower court rejected application of the Black-Scholes option pricing model to the stock options at bar and affirmed dismissal of the complaint for failure to state a claim. It also failed to consider pertinent rules and regulations of the United States Securities and Exchange Commission (sometimes "SEC" or "Commission"). It also undertook to decide upon the application of a Generally Accepted Accounting Principle ("GAAP") without a record of expert testimony.

REASONS FOR GRANTING THE PETITION

Alan Greenspan, Chairman of the Federal Reserve System, said that disclosure of the cost of corporate stock options is an issue of national importance. The Financial Accounting Standards Board is considering whether to require it. What they are talking about is the expensing of stock options on corporate income statements, an intricate, complicated matter involving questions of timing and how to phase it in. It is much more difficult to perfect than the Question Presented in this petition for certiorari, but they are equally important in that they each require the evaluation of stock options under a pricing model such as Black-Scholes, and they each affect a material amount of American wealth, assets, and capital.

The Question Presented is an issue that should be settled by this court. The principal reason is that the Ninth Circuit, as well as other lower federal and state courts, have uttered such substantial disparagement of Black-Scholes, and the evaluation of corporate stock options in general, that they seriously compromise FASB's work. That disparagement is unscientific, ahistorical, and anti- intellectual, but too many judges have accepted it. Meanwhile, out capital markets bear the burden.

1. The Question Presented Is An Important Question Of Federal Law

"[A]n issue of national concern" is what Federal Reserve System Chairman Alan Greenspan said of the possibility that the financial markets do not understand the cost of stock options granted to corporate employees, officers, and directors. He said, "[M]arket values are distorted and real capital resources are being diverted from their most efficient employment." (Submission by Robert H. Herz, Chairman, Financial Accounting Standards

Board, for the Roundtable on *Preserving Partnership Capitalism Through Stock Options For America's Workforce* at the United States Senate, p. 26, May 8, 2003.) (http://www.fasb.org/full_text.pdf). Chairman Greenspan also said, "The notion that you can't value options is flat wrong." *The Wall Street Journal*, p. C-3, May 9, 2003.

Chairman Greenspan was speaking in the context of expensing stock options on corporate income statements. The expensing of stock options occurs long after a stock option plan is approved. Expensing is done during the period from the date that the stock option is granted until it becomes fully vested. (FASB 123 ¶30.) We submit that his remarks are even more pertinent to stockholder approval of the plans under which many stock options are granted, for it precedes the grant of stock options. It is the only time that corporate stockholders get to vote on the matter.

The solicitation of stockholder approval of stock option plans is a frequent event. Solicitations appear in approximately 45 percent of proxy statements, according to Institutional Shareholder Services, Inc., of Rockville, Maryland, the leading proxy statement review firm. *ISS, Setting The Bar For Executive Pay* (http://www.issproxy.com/pdf/Compensation% 20Guidelines.pdf). There are perhaps 10,000 United States companies that solicit annual proxies. *About ISS — Company Profile* (http://www.issproxy.com/about/index.asp). The NASDAQ National Market lists more than 4,000 companies. *About NASDAQ* at 1 (http://www.nasdaq.com/about/about_nasdaq.stm). The New York Stock Exchange lists approximately 2,800 companies. *NYSE Listed Companies* (http://www.nyse.com/listed/1020656067970.html). The grant of options on the stock of publicly held companies to directors and employees has increased. Perry and Zenner, "*CEO Compensation In The 1990s: Shareholder Alignment or Shareholder Expropriation?*" 35 Wake Forest L. Rev. 123 (2000). Data

collected by the United States Department of Labor, Bureau of Labor Statistics, as part of its National Compensation Survey, reveal that in 1999, stock options were granted by 30.5 percent of publicly held companies with more than 100 employees. Crimmel and Schildkraut, "*Stock Option Plans Surveyed By NCS*," *Compensation and Working Conditions*, page 11, table 3, (Spring 2001) (http://www.bls.gov/opub/cwc/archive/spring2001artl.pdf). The percentage of employees receiving stock options pursuant to plans during "normal tenure on the job" was mostly in the 80 to 100 percent range. Crimmel and Schildkraut, at page 14, table 6 n.1.

As Institutional Shareholder Services reports, the cost of a stock option plan to a company and its stockholders can be substantial. *ISS, Setting The Bar For Executive Pay*, *supra* at 3 (Example B). They characterize it as being "among the *most economically significant issues* upon which shareholders are entitled to vote [Italics in original] (*Idem.* at 1). The value of stock held by the public is substantial. The New York Stock Exchange reports that the 2,800 companies listed there have an aggregate value of approximately $13.5 Trillion. *NYSE Listed Companies*, *supra*. In *Kalageorgi v. Victor Kamkin, Inc.*, 750 A.2d 531, 538 (Del. Ch. 1999), *aff.*, 748 A.2d 913 (Del. 2000), the court observed:

> Corporate securities are a species of property right that represent not only a firm's fundamental source for raising capital, but also now a publicly traded commodity that is a critical component for creating both institutional and individual wealth that may affect the economic well-being of entire societies.

The court went on, "calling capital stock 'a species of property right' that is of 'foundational importance . . . to our economic system'." *Grimes v. Alteon, Inc.*, 804 A.2d 256, 260 n.6 (Del. 2002).

2. This Question Should Be Settled By This Court

Only the Supreme Court can do it, for no one else is addressing it except the lower federal courts and the state courts. The issue is not before the Financial Accounting Standard Board, who are instead considering what to do after the plans are approved and the stock options are granted, *i.e.*, whether to require that stock options be expensed. FASB News Release 03/12/03 (http://www.fasb.org/news/nr031203.shtml). Institutional Shareholder Services, Inc. does address this issue, but only for a small fraction of investors, *i.e.*, its 950, or so, institutional clients. *About ISS*, *supra*.

Only the courts have addressed this issue and only at the urging of petitioner's counsel. *See Shaev v. Hampel*, 2002 WL 31413805 at *5 n.8 (S.D.N.Y. 2002). The decisions have all been wrong and for a variety of bad reasons.

The earliest cases to reject a Black-Scholes disclosure requirement were based largely on the theory that director and officer stock options could not be evaluated. *Resnik v. Swartz*, 2001 WL 15671 at *1 (S.D.N.Y. 2001) (Black-Scholes value of a stock option "can only be described as a best guess"); *In re 3Com Corp. Sh.Lit.*, 1999 WL 1009210 (Del. Ch. 1999) (as to Black-Scholes, we have "consistently taken a rather jaundiced view of the valuations and their reliability," at *4 n.17, "the Black-Scholes Option Pricing Model is neither sufficiently reliable nor necessary to apprise shareholders of the value of the options in question," at *6); *Cohen v. Calloway*, 246 A.D.2d 473, 667 N.Y.S.2d 249 (1st Dept. 1998) (it is "so imprecise that its inclusion probably would have done more harm than good").

The first case was *Lewis v. Vogelstein*, 699 A.2d 327, 331-32 (Del. Ch. 1997). There the court announced, 699 A.2d at 331:

> Significant doubt exists whether the Black-Scholes option-pricing formula or other, similar option-pricing models, provide a sufficiently reliable estimate of the value of the options with terms such as those granted to the outside directors of Mattel. [Footnote omitted.]

The court went on to explain that the Black-Scholes model posits publicly traded or assignable options, and it held that early exercise will further reduce their value.

The "[s]ignificant doubt" expressed by the court on the reliability of stock option evaluations is "flat wrong" according to Chairman Greenspan (*The Wall Street Journal*, *supra*) and the unassignability of stock options is irrelevant, for that does not affect the cost to issue them. Bodie, Kaplan, Merton, "*For The Last Time: Stock Options Are An Expense*", Harvard Bus. Rev., March 1, 2003, 2003 WL 9953511 at page 4. Moreover, the cost reduction of early exercise is "significantly overstate[d]." (*Idem.* at page 12) One of the authors of this Harvard Bus.Rev. article, Dr. Merton, shared in one half of the 1997 Nobel Prize in Economic Science, with Dr. Scholes, for his work on the Black-Scholes option pricing model (http://www.nobel.se/economics/laureates/1997/index.html). Fischer Black died in 1995 (E-74).

For the courts to accept the argument that Black-Scholes disclosures are unreliable is to accept "expertise that is *fausse* and science that is junky." *Kumho Tire Co., Ltd. v. Carmichael*, 526 U.S. 137, 159 (1999) (concurring opinion of Justices Scalia, O'Connor, and Thomas).

The lower court held that these four cases were not inconsistent with *Custom Chrome, Inc. v. Comm.*, 217 F.3d 1117, 1124 n.10 and accompanying text (9th Cir. 2000) (Black-Scholes option pricing model is "well established and reliable" and capable of determining the value of stock options with "reasonable accuracy.") (6a-7a.) The lower court held that its decision in "*Custom Chrome* in no way endorses the use of Black-Scholes to value options granted to outside directors." (7a.) The lower court affirmed the district court's reliance on "all four of these cases [that] held that Black-Scholes valuations are not material as a matter of law." (18a-19a.) But to the extent that the four cases addressed materiality, they substantially relied on the belief that Black-Scholes was plagued by significant doubt as to its reliability, a belief that is refuted by Chairman Greenspan and Dr. Merton.

The lower court, 9a-10a, evinced a further disagreement with the Financial Accounting Standards Board in failing to reject the Proxy Statement representation that a stock option has "no value," 9a, unless the stock price increases. FASB 123, ¶¶139-42; Ciesielski, "*Another Options War*," Barron's, p.39 (May 5, 2003) available at 2003 WL-Barron's 6977368; Thomas and Martin, "*The Determinants of Shareholder Voting On Stock Option Plans*," 35 Wake Forest L. Rev. 31, 41 (2000) ("Valuing a stock option requires using the Black-Scholes formula and is not an intuitive process. [Footnote omitted]").

Like some other courts, the Ninth Circuit suggested that the Securities and Exchange Commission formulate a rule on this issue, 12a, citing *Resnik v. Swartz*, 303 F.3d 147, 154-55 (2d Cir. 2002), which in turn, borrowed the idea from *Lewis v. Vogelstein, supra*, 699 A.2d at 332-33. But, after the lower court, like so many other courts, held that Black-Scholes does not work on these stock options (and decided it as a matter of

law on a motion to dismiss for failure to state a claim), no rule from the Commission or FASB would be free of suspicion by the public, unless this court decides that those courts are wrong.

The lower court held that the proxy statement complied with 17 C.F.R. § 240.14a-101 (Item 8) which refers to 17 C.F.R. §§ 229.402(c) and (g). (8a-9a.) It noted that Item 402(c), 32a-34a, expressly provides for Black-Scholes disclosures in proxy statements, but only for executive officers and not directors. On the other hand, § 402(g), 34a-35a, concerns proxy statement disclosure of directors' compensation, but omits references to Black-Scholes evaluations.

The lower court overlooked 17 C.F.R. § 240.14a-101 (Item 10), 29a-31a, concerning stockholder voting on new compensation plans for, *inter alia*, directors. It requires that the proxy statement disclose the "Dollar Value," 30a, of directors' "noncash compensation" if determinable, 29a. Item 10 expressly addresses the requirements for obtaining stockholder approval of new compensation plans, and it expressly contains the requirement to state the "Dollar Value" of non-cash benefits of the proposed new plan. Item 10 applies to directors, 30a, 31a, and is not limited solely to officers.

The lower court should not have used the principle *inclusio unius est exclusio alterius*, for §§ 402(c) and (g), without considering Item 10, nor where the result seems "to conflict with the objective of the statute it implements," *Sec. of Labor, Mine Safety & Health Admin. v. Western Fuels-Utah, Inc.*, 900 F.2d 318, 320 (D.C. Cir. 1990), i.e., the protection of investors. 17 C.F.R. § 240.14a-9, 27a; *see Zell v. Intercapital Income Securities, Inc.*, 675 F.2d 1041, 1044 (9th Cir. 1982); *Maldonado v. Flynn*, 597 F.2d 789, 796 n.9 and accompanying text (2d Cir. 1979). In *Shook v. D.C. Financial Responsibility*

& Mgmt. Asst. Auth., 132 F.3d 775, 782 (D.C. Cir. 1998) the court suggested its use "as a starting point in statutory construction — not as a close-out bid." *See also Cheney R. Co. v. ICC*, 902 F.2d 66, 68-69 (D.C. Cir. 1990).

The lower court's statement that FASB 123 is only concerned with accounting in financial statements for options granted as compensation, and that it does not address proposed compensation in a proxy statement (7a-8a), is inconsistent with the position of the SEC that financial information should be reported using GAAP, *i.e.*, Generally Accepted Accounting Principles, even if it is not in "financial statements." *Matter of Trump Hotels & Casino Resorts, Inc.*, 2002 WL 58566 ¶III A-D (SEC Rel. No. 34-45287, January 16, 2002) ("using that non-GAAP figure [in a press release] was materially false"). As FASB 123 ¶149, states, corporate stock options are equity instruments. As such, they must be reported, wherever disclosed, consistently with GAAP according to FASB.

FASB 123 includes a thorough explanation of stock options and what they are worth and why. It quantifies its observations and conclusions and in no way is limited to financial statements. It reflects the way the world of corporate compensation actually works. No corporate human resources department and no compensation consultant would propose any stock option grant or stock option plan without making a fair value assessment, either using Black-Scholes or some similar method. (FASB 123 ¶373.) The lower court should have refrained from adjudicating the scope of FASB 123 in the absence of expert accounting testimony (*SEC v. Caserta*, 75 F. Supp. 2d 79, 90-92 (E.D.N.Y. 1999) ("a fact-specific issue" *Id.* at 91)), for the issue presented is whether the information is consistent with GAAP.

The development of FASB 123 was a project that extended from 1984 to 1995, and many opinions were considered. (FASB 123 ¶¶365-79.) FASB statements are part of and constitute the primary level of GAAP. In Accounting Series Release No. 150, Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, 39 F.R. 1260 [1937-1982 Transfer Binder, Accounting Series Releases], Fed. Sec. L. Rep. (CCH) ¶72,172 (Dec. 20, 1973), the SEC endorsed the establishment of FASB and said that its Statements and Interpretations will be considered as having substantial authoritative support, and those contrary to them will be considered to have no such support. The SEC has recently reconfirmed its support for FASB. SEC Rel. Nos. 33-8221; 34-47743; IC 26028; FR-70 (April 25, 2003) (http://www.sec.gov/rules/policy/33-8221.htm).

There is no need for the SEC to follow the courts' recommendation to make a new rule for disclosure. The SEC has already done that. Section 14(a), 26a, of the 1934 Act and Rule 14a-9, 17 C.F.R. § 240.14a-9, 27a, require full and fair disclosure of all material facts. *J.I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964) (§ 14(a) prevents "inadequate disclosure in proxy solicitation"); *Shaev. v. Saper*, 320 F.3d 373, 379 (3d Cir. 2003) ("a highly important rule in the corporate life of this nation"); Aranow and Einhorn, "*Proxy Regulation: Suggested Improvement*," 28 Geo. Wash. L. Rev. 306 (1959) ("the states did nothing to cope with the problem," at p. 306). Item 402(g), 34a, of Regulation S-K requires disclosure of the amount of directors' compensation. Item 10, 29a, 30a, of Schedule A requires disclosure of the Dollar Value of non-cash benefits. The SEC requires that financial information be disclosed according to Generally Accepted Accounting Principles, and the SEC says that FASB is the leading authority on those Principles, and FASB says to use an option pricing model to disclose the

value of stock options, and the federal courts have consistently held that directors' compensation is material. This is particularly so at bar where the directors have voted themselves annual stock options worth more than 20 times the annual cash retainer and without the advice of an independent consultant. Gershon Aff. ¶9, Exh. 7 (E-55, 75).

If the defendants were actually "children in kindergarten", they might be allowed to adhere to an honest belief that a hyper-literal reading of Reg. S-K and Schedule 14A, in isolation from all other learning, excuses disclosure, but we submit that they should be treated as adults and should be held to at least as high a standard as their stockholders. *Richland v. Crandall*, 262 F. Supp. 538, 554 (S.D.N.Y. 1967) (perhaps the first formulation of this idea).

FASB 123, at ¶373, reports that Black-Scholes values of stock options are widely used to design compensation packages. As the result of the lower court's decision, although insiders get a prior view of the value of the stock options, the stockholders, who are solicited to approve them and who must indirectly pay the cost of that value, do not.

The purpose of the SEC proxy statement rules and regulations are to inform the stockholders so that they can "vote prudently." *Galef v. Alexander*, 615 F.2d 51, 63 (2d Cir. 1980). The regulations have become exceedingly intricate over the years, for the SEC has tried to combine a system of uniform and consistent presentation with full and fair disclosure. These complicated regulations are not a game to be played for its own sake, the point being to beat the system, *i.e.*, to disclose the facts, but to delete the truth. We submit that the time is over for corporate games. *No. 84 Employer Teamster Fund v. America West Holding Corp.*, 320 F.3d 920, 946 (9th Cir. 2003);

Houbigant, Inc. v. Deloitte & Touche, LLP, 753 N.Y.S.2d 493, 498 (1st Dept. 2003). SEC Commissioner Cynthia A. Glassman, *Speech: Improving Corporate Disclosure — Improving Shareholder Value*, April 10, 2003 (http://www.sec.gov/news/speech/spch041003cag.htm) at page 3 of 9, said:

> GAAP's complex of rules creates situations where lawyers and accountants may play games with the rules, rather than focusing on the principles underlying them. The more specific the rules, the easier companies may find it to structure transactions specifically to circumvent them. This, of course, if the problem with "bright line" rules: the impulse is to make sure the line isn't crossed instead of making sure the books reflect the true economic condition of the company.

What Commissioner Glassman said of the rules of Generally Accepted Accounting Principles could as easily be said of the rules of the Securities and Exchange Commission.

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

A. ARNOLD GERSHON
BALLON STOLL BADER & NADLER, P.C.
Attorneys for Petitioner
1450 Broadway
14th Floor
New York, New York 10018-2268
(212) 575-7900